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21/04/2017

CCP Sub-Panel No. 10

c/- CCP Work Program, AER

AER Board

Moston Neck Co-ord Director – Sub-Panel 10

Australian Energy Regulator

By email: ccp@aer.gov.au

Dear Moston,

**Re: Preliminary framework and approach (F&A) Ausgrid, Endeavour Energy and Essential Energy**

Please find attached our submission in relation to the above F&A as per the Schedule of Work (Attachment A of the Submission).

### Summary of Issues

This submission responds to the main elements of the Preliminary Framework and Approach for NSW electricity distribution businesses, 2019-24 regulatory proposals.

The table “Summary of Issues” on pages 3 and 4 provides a summary response to each element of the Preliminary F&A proposed by the AER.

### Other Matters

In preparing this submission, the subpanel has identified four important issues that will impinge on the NSW distribution business regulatory processes, but that are broader in scope than a single group of regulatory resets, these matters being:

1.     Street lighting. We suggest that a binding code is needed for street lighting that the AER can play a role in requiring. There are also broader policy matters needing Local, State/Territory and Commonwealth government cooperation, which could more likely occur under a COAG umbrella.

2.     Form of Control. The use of revenue caps is supported, for the current processes, but we suggest that a more detailed review of forms of control and effectiveness of a Revenue Cap regime should be on the AER’s future work program, so that there is more consideration of approaches prior to the 2024-29 and subsequent regulatory periods.

3.     Incentives for improved consumer engagement. There should be some benefit to network businesses that engage meaningfully with consumer interests resulting in consumer benefit.

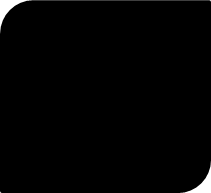
4.     Tariff development. All network businesses have now developed Tariff Structures Statements and tariff setting is a more overt process in regulatory proposals. The extent to which the tariff setting process is reflected in regulatory proposals is an emerging question.

We also note that there are some parallel processes that the AER is undertaking that may impact on the distribution businesses’ approach to aspects of their regulation proposals, specifically ring-fencing and revised guidelines of incentive schemes, DMIS and STPIS in particular. The CCP will maintain an active interest in these processes.

Signed



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| --- |
| Mark Henley  **Sub-panel Chairperson**  Email: [markH@unitingcommunities.org](mailto:markH@unitingcommunities.org)  Mobile: 0404067011 |



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# Submission to the Australian Energy Regulator (AER)

# Consumer Challenge Panel Sub-Panel 10

# Response to Preliminary framework and approach

# Ausgrid, Endeavour Energy and Essential Energy

# Regulatory control period commencing 1 July 2019

**Sub-Panel 10**

**Louise Benjamin**

**Eric Groom**

**Mark Henley**

**Mike Swanston**

**21 APRIL 2017**

# Summary of Issues Addressed

The following table sets out our understanding of the AER’s proposed approach, as specified in the Preliminary Framework and Approach, with our response summary. Sections 2 – 9 of this submission provide discussion and argument relating to our summary responses.

|  |  |
| --- | --- |
| **Preliminary F&A Element - NSW** | **CCP10 Response Summary** |
| **Issue 1: Classification of distribution services** | **Pages 6 - 12** |
| Classification of services into groups as:   1. Direct Control (common distribution services, 2. Ancillary services); 3. Negotiated; and Unclassified (Metering services, 4. Connection services, 5. public lighting and 6. unregulated distribution services) | The CCP supports these classification groups.  The CCP supports consistency across jurisdictions where possible |
| Common Distribution services to be classified as “Direct Control Services” | Agreed |
| Emergency Recoverable works as Common Distribution services and therefore direct control services | Agreed on the basis the EBSS applies to all NSW DBs |
| Metering Services to be classified differently than in the past due to introduction of meter coordinator functions with new metering arrangements from 1/12/17.   * Type 1-4: unclassified * Type 5,6 meters: not classified * Type 7: direct control | Type 1-4: agreed  Type 5-6: agreed as legacy services  Type 7: agreed |
| Metering coordinator, metering provider and metering data provider: Unregulated services. | Agreed as this is necessary to facilitate competition under the AEMC contestability framework and the ring-fencing guideline |
| Connection Services   * Premise Connections: not classified * Extensions – db makes financial contribution: standard control * All other extensions: not classified * Augmentations: Standard Control | Agreed |
| Ancillary Services: Direct Control | Agreed |
| Public Lighting: Direct Control | Partial agreement. CCP recommends that AER assist in negotiations for a binding Public Lighting Code to improve consistency of performance standards and emergence of developing technologies. Greenfield developments should be classified as negotiated services |
| **Issue 2: Control mechanisms** | **Pages 12 - 15** |
| Revenue cap for standard control services | Agreed The transfer of demand risk to customers should be reflected in pricing |
| Price caps in individual services for alternative control services. | Agreed |
| Efficient Tariff Structures can operate under all forms of control mechanism, including a revenue cap | Agreed |
| **Issue 3: Incentive schemes** | **Pages 15 - 18** |
| EBSS: Apply to all NSW DB’s | Agreed. Important it is applied to all DBs |
| CESS: Apply to all NSW DB’s | Agreed ( (Note CSIRO / ENA “Network Transformation Roadmap developments) ”[[1]](#footnote-1) |
| STPIS: Applies to all NSW DBs (appropriate VCR value sought) | Agreed subject to further comment after finalisation of AER review |
| DMIS and DMIA: Apply to all NSW DB’s | Agreed subject to further comment after finalisation of AER review |
| **Issue 4: Expenditure forecast assessment guideline** | **Pages 18 - 20** |
| Expenditure Forecast Assessment Guideline: Have regard to the assessment tools in the guideline | Supported. |
| **Issue 5: Depreciation** | **Pages 20 - 22** |
| Use forecast depreciation approach to establish value of the RAB as beginning and end of the 2019-24 period | Use of forecast deprecation supported. |
| **Issue 6: Dual function assets** | **Page 22** |
| Apply Transmission pricing to Ausgrid | Agreed as per Ausgrid request |
| Apply distribution pricing to Endeavour Energy | Agreed as per Endeavour request |
| No dual function assets exist for Essential Energy | N/A |
| **Consumer engagement** | **Pages 22 - 23** |
| Consumer engagement is not referred to in the F&A | CCP recommends final F&A should refer to the imperative for the 3 NSW distribution businesses to engage with consumers |
| Application of “Better regulation” Consumer Engagement Guideline | CCP expects that the AER’s consumer engagement guideline will be applied to ‘best endeavours’ in developing regulatory proposals by each of the 3 NSW distribution businesses |

Source: Compiled by Consumer Challenge Panel using AER Preliminary Framework and Approach, NSW Electricity Distribution, 2019-24.

# Background

* Meetings with the 3 NSW distribution businesses:
  + the 4 members of CCP sub-panel 10 met with the CEO and other senior executives of Ausgrid on 16 March 2017
  + the 4 members of sub-panel 10 met with the acting CEO and other senior executives of Endeavour Energy on 16 March 2017
  + the 4 members of sub-panel 10 (the CCP) met with the CEO and other senior executives of Essential Energy on 23 March 2017
* Consultation with consumer interest groups:
  + Mike Swanston attended Ausgrid's fifth Customer Consultative Committee workshop on 5 April 2017
  + Mike Swanston and Louise Benjamin attended the AER’s stakeholder forum on the F&A on 11 April 2017
  + Mark Henley met with Kristal Burry from Public Interest Advocacy Centre on 15 March 2017

# Issue 1: Classification of distribution services

### The classification of services by the AER affects the costs that can be recovered by the NSW distributors, where those services are classified as direct control services and regulated by the AER. The introduction of the Ring-fencing Guideline electricity distribution (the Ring-fencing guideline) in November 2016[[2]](#footnote-2) also affects the distributors by requiring them to separate the provision of unclassified services and passing them to a ring-fenced affiliate. The F&A classification decisions directly impact the distributors’ ring-fencing obligations under the Ring-fencing guideline. The CCP also notes that the Australian Energy Market Commission (AEMC) is currently assessing rule changes proposals from the COAG Energy Council and Australian Energy Council on the contestability of energy services.

### AER’s preliminary position

Overall, the AER’s preliminary position is to change the classification of some NSW distribution services for the 2019−24 regulatory control period. The AER’s preliminary position is to group distribution services provided by the NSW distributors as:

* common distribution services (formerly *'network services'*)
* ancillary services
* metering services
* connection services
* public lighting services and
* unregulated distribution services.

**CCP view**

The CCP supports the AER’s preliminary classifications above and the process discussed in the F&A on pages 15-19. The CCP further supports the AER’s objective to “*provide improved clarity, consistency across jurisdictions as far as practicable, predictability in how new distribution services might be classified and service descriptions that better align with the services being provided*.” (p14 F&A).

### Common distribution services

**AER’s preliminary position**

This service group was formerly called *'network services'*. However, to avoid confusion with the defined terms in chapter 10 of the NER (National Electricity Rules), the AER proposes to rename this service group *'common distribution services',* although it is open to suggestions for alternative names. (We suggest that “core distribution services’ might be a better name as it refers to the ‘core business’ of a network distribution service provider)

Common distribution services are concerned with providing a safe and reliable electricity supply to customers. Common distribution services are intrinsically tied to the network infrastructure and the staff and systems that support the shared use of the distribution network by customers. The AER’s preliminary position is to classify common distribution services as direct control services. The AER considers that there is no opportunity for third parties to enter the market for the provision of common distribution services. The AER’s preliminary position is to retain the current standard control classification for common distribution services as there is no potential to develop competition in the market for common distribution services because of the barriers to third party entry referred to above.

**CCP view**

The CCP agrees with the suggestion to rename these services as common (or core) distribution services. The CCP also agrees that these services should be classified as standard control services because:

* of the lack of potential competition due to the high barriers to entry,
* there is no material effect on administrative costs for the AER, the NSW distributors, users or potential users by continuing this classification; and
* of consistency in classification in NSW and all other NEM jurisdictions as standard control services.

1. Emergency recoverable works

AER’s preliminary position

The AER’s preliminary position is for emergency recoverable works to be subsumed into the common distribution services group and classified as direct control services and standard control services. Following the introduction of the AER’s Ring-fencing guideline, if the AER left this service as an unregulated distribution service it would require it to be ring-fenced by the NSW distributors.

**CCP view**

The CCP agrees that emergency recoverable works should be classified as common distribution services and that it is not in the long-term interests of consumers for these services to be ring-fenced as these services are inherently part of the safe and reliable electricity supply to customers. However, the CCP would be concerned if the network distributors could recover twice for the provision of this service: once from consumers and again from the third party who caused the damage. The CCP notes that the distributors are incentivised under the Efficiency Benefit Sharing Scheme (EBSS) to make operating expenditure (opex) savings of this nature and any recovery from a third party would be netted off the regulatory asset base (RAB) and treated like a capital contribution. Whilst the EBSS applies to the distributors this over-recovery will be avoided. The CCP agrees with the AER’s proposal to adopt this approach across all NEM jurisdictions. Note also our response to EBSS as part of our discussion about incentive arrangements, section 5,

### Metering services

The CCP notes that the AER’s metering classification decisions in the F&A are designed to reflect the recent rule change introduced by the AEMC to open up competition in metering services and give consumers more opportunities to access a wider range of metering services.[[3]](#footnote-3)  The new arrangements will commence on 1 December 2017 and have resulted in the AER changing classification of some metering services for the 2019−24 regulatory control period.

**AER’s preliminary position**

*Type 1 to 4 metering services*: as these meters are competitively available, the AER does not currently regulate them in NSW or in most other jurisdictions and the AER’s preliminary position is for them to remain unclassified.

*Type 5 and 6 metering services*: Once the new rule is in effect the NSW distributors will no longer be permitted to install or replace existing meters with type 5 or 6 meters, making then redundant services. The AER’s preliminary position is to not classify these services for the 2019−24 regulatory control period.

*Ancillary services – Metering*: see discussion of ancillary services in 5 below.

*Type 7 metering services*: As the NSW distributors are the monopoly providers of type 7 metering services in NSW, the AER’s preliminary position is to classify type 7 metering services as direct control services and as standard control services. This is a continuation of the current classification of type 7 metering services.

*Metering coordinator, metering provider, metering data provider***:**  The AER’s preliminary approach is to not classify these services and to treat them as unregulated distribution services. From a ring-fencing perspective, the provision of these services will need to be separated from the provision of direct control services.

The AER bases this classification on the future contestability in metering and the significant potential to develop competition for the provision of these services. Given the emerging nature of this competition the AER notes that it may favourably consider interim ring-fencing waiver applications from the NSW distributors around office and staff sharing obligations.

**CCP view**

The CCP welcomes the introduction of the AEMC’s metering contestability framework as this is in the long-term interests of consumers. Contestability and the emergence of competition will lead to competitive pressure on the NSW distributors and will lead to more efficient pricing in metering services.

The phasing out of type 5 and type 6 interval and accumulation meters, supported by ancillary services being classified as alternative control services, will encourage greater penetration of smart meters. This should lead to better information for consumers with the potential for them to better self-manage their electricity consumption. In the future, this consumption information should also lead to improved demand management initiatives for the distributors.

The CCP agrees with the AER’s classification decisions for metering services, as combined with the Ring-fencing guideline, they are consistent with fostering competition in this nascent third party market. The CCP acknowledges the distributors concerns about transitional arrangements and the AER’s concern about customers being confused about their ability to source metering services from providers other than the distributors. However, the CCP urges the AER only to grant short term waivers in relation to sharing personnel, as it is in the long-term interests of consumers for the distributors to establish separate ring-fenced metering co-ordinators and other personnel. Transitional arrangements should include a clear communications strategy to inform consumers about changes

### Connection services

**AER’s preliminary position**

The ability of customers to choose whether a NSW distributor or an accredited service provider (ASP) will perform connection works means there are only limited circumstances where the AER regulates connection services in NSW. The AER’s preliminary position does not differ from the 2014−19 regulatory control period.

*Extensions*: only extensions performed by the distributor or where the distributor makes a financial contribution to the extension will be classified by the AER as standard control services. All other extensions are unregulated distribution services and will not be classified.

*Augmentations*: The AER’s preliminary position is that the NSW distributors possess significant market power in providing augmentations to the shared network and do not permit third parties to perform augmentations because of the potential impact on the safety, security and reliability of the network. This means that a third party can only perform an augmentation at a distributor's discretion. The AER’s proposed approach is to classify augmentations as direct control services and as standard control services.

CCP view

The CCP agrees with the AER’s classifications and notes that its approach of directly regulating augmentations is consistent with the classification of connection services in other NEM jurisdictions as direct control services. In practice, there is little alternative as the distributors are not able to directly attribute augmentation costs to individual customers.

The CCP is concerned that the NSW distributors have limited incentive in supplying connection services particularly augmentation services in a timely way as connection services are excluded from STPIS which is discussed below.

### Ancillary services

**AER’s preliminary position**

The distributors may provide ancillary ‘as needs’ services to customers including metering services on a regulated cost recovery basis. As the AER notes, there are important ancillary metering services which will facilitate increased competition in the metering market. The AER’s preliminary position is to classify these services as direct control services and as alternative control services.

**CCP view**

The CCP supports this classification as it will be more likely to facilitate new entry into the provision of ancillary services, such as in metering, due to the obligation on distributors to provide discrete pricing to the customer. The CCP supports classifications that are consistent with increased competition in metering and other individual customer services, where such competition is likely to reduce costs and improve services for customers

### Public lighting

**AER’s preliminary position**

The AER has concluded that there is insufficient evidence to move away from the presumption that public lighting services in NSW should remain as alternative control services. Further the AER proposes to include emerging public lighting technologies as part of the public lighting services group.

**CCP view**

As discussed below in Issue 2: control mechanisms, the CCP is concerned that the AER’s decision may preclude the emergence of pubic lighting technologies and greater contestability in this sector during the 2019-24 regulatory period. As technologies can develop rapidly it is not possible to foresee those developments 2 years out from the commencement of the regulatory period. The CCP believes that technology developments are likely given the different competitive and regulatory environment that operates in Victoria and South Australia.

The CCP is aware that there is a strong degree of frustration among local Councils about the non-binding nature of the NSW Public Lighting Code and the resultant inconsistent performance levels given to some customers. This is exacerbated by public lighting being outside the STPIS. Due to monopoly ownership of the assets, contestability is unlikely in the current regulatory environment.

The CCP believes that regulation of the price being charged by distributors as proposed by the AER, is necessary but is an insufficient response to this issue. The CCP believes that public lighting in greenfields developments should be separated from public lighting services and should instead be classified as negotiated service. All other emerging technologies would remain as part of the alternative control services classification for this regulatory period.

However, the CCP believes that all public lighting services should cease to be regulated as alternative control services in the short-medium term. The CCP intends to become involved in the development of the Public Lighting Code and urges the AER to also assist in achieving a binding Public Lighting Code for NSW. The CCP believes that a binding code would lead to negotiated outcomes between distributors and local Councils and would be a positive step towards contestability of this market sector. The CCP is concerned about public safety, the inconsistent performance standards and the stifling of technology innovation in the provision of public lighting in NSW.

### Unregulated distribution services

**AER’s preliminary position**

In approaching classification of unregulated distribution services, distributors (and the AER) will need to consider if the service would be better offered by an affiliate and therefore not classified. Where a distributor does not wish to set up a ring-fenced affiliate to supply the service the AER would classify this as a distribution service and as an alternative control service. As part of the distribution determination, the AER would then set a cost-reflective price for the service based on information provided by the distributor. The AER is expecting that there will be several distribution services that distributors may propose to provide on a ring-fenced basis that are currently unregulated services.

**CCP view**

The observations made by the AER on unregulated distribution services merely reflect the consequence of the introduction of the AER’s Ring-fencing guideline.

During the AER’s stakeholder forum on 11 April 2017 the AER stated that it expects some of the NSW distribution businesses will be asking for exemptions from the start of the ring-fencing provisions. The AER noted that it would consider limited and temporary waivers from ring-fencing obligations. Examples given were where a distribution business has a contractual arrangement that may extend past the start of the regulatory period, and the AER might consider a temporary exemption until the expiry of the contract was better for customers rather than incurring the costs to set up new agreements with a new arms-length entity.

The CCP recognises that the introduction of the Ring-fencing guideline will impose an increased administrative burden on the NSW distribution businesses. This burden will be greatest during the first regulatory period that the Ring-fencing guideline is in operation as services are passed from the network to the ring-fenced affiliate. The CCP supports the objectives of the Ring-fencing guideline and accepts that some flexibility will be needed from the AER in its implementation.

# Issue 2: Control mechanisms

### AER’s preliminary position

The AER’s preliminary position is to apply the following forms of control in the 2019–29 regulatory control period:

* Revenue cap — for services the AER classifies as standard control services.
* Caps on the prices of individual services — for services the AER classifies as alternative control services.

This continues the current form of control applying to these services.

### CCP view

#### Form of Control for Standard Control Services

The CCP supports the AER’s proposal to apply a revenue cap as the form of control for standard control services for the NSW distribution businesses.  In so doing the CCP notes that there has been relatively limited experience with revenue caps and the decision on the form of control is a significant issue for all network businesses.  While the form of control is set within each Framework and Approach review, there would be merit in the AER undertaking a broader review of the form of control to be applied across all network businesses once there has been more experience with revenue caps.  This review would need to consider the interface between the form of control and performance incentive schemes, such as the DMIS.

In proposing the adoption of a revenue cap the AER considered:

* the implications for efficient tariff structure
* administrative costs
* previous regulatory arrangements
* consistency within and between jurisdictions
* revenue recovery
* price flexibility and stability and
* incentives for demand management.

Overall, we agree with the AER’s assessment of the options against these criteria, but another important criteria is risk allocation.

The key difference between a revenue cap and a revenue yield (i.e. an average revenue cap) is that a revenue cap transfers demand risk during the regulatory period from the network business to its customers. This removes one of the key systematic risks for the network during the regulatory period: the impact of the variations in energy usage with macroeconomic cycles. Economic downturns reduce energy consumption and hence network revenues under a price cap, or revenue yield cap. Given that the network costs are relatively fixed in the short term, the impact of these changes on profits is magnified. Under a revenue cap, changes in demand have only a short-term cash flow effect.[[4]](#footnote-4) Furthermore, the AER’s proposed approach to the adjustments reduces the lag in the adjustments for variations in demand. This change to systematic risk should be considered in assessing the risk term (beta) in the cost of capital to ensure prices to consumers reflect the reduced risk for the network business relative to a price or revenue yield cap.

Another factor supporting a revenue cap is that it reduces the importance of the demand forecasts in setting the regulatory controls. Under a price cap a network business can benefit from under-forecasting demand growth, resulting in the regulator and stakeholders devoting significant resources to the scrutiny of the demand forecasts. This should, to a degree, simplify regulatory reviews and reduce the costs for network businesses, the AER, and other stakeholders relative to weighted average price or revenue yield cap.

#### Form of Control for Alternative Control Services

The CCP supports the AER’s proposal to apply caps on individual prices as the form of control for alternative control services. This can help ensure that the potential for competition is not constrained and that other consumers of standard control services do not cross-subsidise consumers of alternative control services.

Alternative control services are services that are either potentially contestable or are used by only a small number of consumers on a discretionary basis. In proposing the adoption of a revenue cap the AER considered:

* the implications for the potential for competition
* administrative costs
* existing regulatory arrangements
* consistency within and between jurisdictions and
* cost reflective prices.

There is a presumption that where feasible, effective competition can be the best means of aligning service delivery and pricing with the long-term interests of consumers. Hence, for services that are potentially contestable, such as type 5 or 6 meters or public lighting, consideration of the implications of the form of regulation for competition is a key factor in deciding the form of control. The various forms of average price and revenue control provide greater flexibility in pricing. But where competition may be possible the potential competitors may be concerned that this flexibility in pricing and cost allocation could be used to protect the network’s market position. Establishing specific prices for these services can also provide consumers with greater assurance that such cross-subsidies are limited, if not eliminated.

The prices set for the alternative control services, such as street lighting, would be maximum prices. It would be open to the networks to negotiate lower prices with councils, possibly in response to competitive pressures. However, as alternate control services and standard control services are separately regulated, such ‘discounts’ would not be funded from standard control services revenue.

Councils may wish to negotiate innovative street lighting services or a different allocation of functions between the network and the council. In some cases, this may result in higher costs, but better service. A fixed schedule of maximum prices may inhibit this. In Victoria and South Australia emerging public lighting technologies and greenfield developments are classified as negotiated services to provide greater flexibility. The issue of classification was discussed earlier in Issue 1, but it may be possible to provide greater flexibility and adaptability while classifying all public lighting services as alternative control services. The AER notes that there is considerable flexibility in the form of price control for alternative control services. One option within this may be to set standard ‘default’ prices, but allow variations from these – including higher prices – where councils and the networks negotiate a service agreement covering public lighting. This avoids the need to define what is an ‘emerging’ technology or the scope of service. However, the AER would need to specify process requirements for a negotiated agreement. The question of whether the AER would need to approve or endorse the negotiated agreement would also need to be considered.

# Issue 3: Incentive schemes

**AER’s preliminary position**

Incentive schemes encourage network businesses to manage their networks in a safe, reliable manner that serves the long-term interests of consumers. They provide network businesses with incentives to only incur efficient costs and to meet or exceed service quality targets.

The AER’s preliminary position is to apply each of the available incentive schemes to each of the NSW network businesses:

1. Efficiency Benefit Sharing Scheme (EBSS)
2. Capital Expenditure Sharing Scheme (CESS)
3. Service Target Performance Incentive Scheme (STPIS) and
4. Demand Management Incentive Scheme (DMIS).

The final F&A approach on the application of incentive schemes is not binding on the AER nor the NSW network businesses.

Status of the incentive schemes

The incentive schemes, in particular the EBSS, were not universally applied to the NSW distributors in the previous regulatory period (2015-19). It is noted that all incentive schemes are planned to apply to all 3 NSW distributors in 2019 – 24. The CCP supports this.

Both the DMIS and STPIS are currently under review by the AER, with draft statements and notes due to be published in May 2017 (DMIS) and June 2017 (STPIS). The detailed nature and application of these two schemes will be considered once these draft statements are released.

Regarding the STPIS, initial responses to the review by Ausgrid, Essential Energy and Endeavour Energy tend to support the existing framework, with recommendations generally around the form of calculation of performance targets.

In the current discussion on the DMIS, responses from the distributors are more guarded, with concerns around the type of benefit sharing scheme, investment opportunities and the relationship between the DMIS and other efficiency incentive schemes. The DMIS is also drawing interest from a wide public audience.

It is noted that the distributors have expressed particular views on the application of the STPIS and other incentive schemes to the AER directly, and the AER’s position is to consider these views and the issues raised in submissions during the review process for the STPIS and DMIS.

**CCP view**

The CCP supports the application of the incentive schemes proposed in the F&A as:

* efficiencies in capital and operating expenditure will benefit customers and
* the balancing impact of the STPIS is required to ensure appropriate service performance.

Given the reviews under way for the DMIS and STPIS there is a need to take a ‘wait and see’ approach by the CCP and the NSW distributors, until meaningful responses can be made regarding the STPIS and DMIS later this year. The CCP intends to present specific feedback on these two schemes after the draft statements are released by the AER.

Within the context of the CCP’s broad support for the incentive schemes, the following detailed comments are offered:

1. EBSS

The EBSS must provide for a fair sharing between service providers and network users from efficiency gains and efficiency losses. In considering this approach, the following matters remain of key impact to customers:

* the need to provide distributors with continuous incentives, so far as is consistent with economic efficiency, to reduce operating costs without reducing service delivery or network performance and
* the possible effects of the scheme on incentives for the implementation of non–network alternatives, and the cost impact of operational costs and ultimately tariffs to defer capex (related to CESS and DMIS).

1. CESS

Under the CESS a distributor retains 30 per cent of an underspend or overspend, while consumers retain 70 per cent of the underspend or overspend. This means that for a one dollar saving in capex the distributor keeps 30 cents of the benefit while consumers keep 70 cents of the benefit.

The relationship between the CESS and investment in demand management initiatives to address energy at risk and the setting of reliability standards is of prime importance.

The CCP notes the changing nature of capital investment requirements in networks, largely because of changing customer energy requirements as articulated in the ENA’s Network Transformation Roadmap (the Roadmap). The CCP is very interested in the application of the Roadmap’s approach into the capital investment plans of the NSW distributors.

1. STPIS

While the regulatory regime encourages a business to improve its operating and capital efficiency, the STPIS is designed to ensure that this increase in efficiency is not at the expense of deterioration in service performance for customers. Further, the STPIS is designed to encourage a network business to improve its service performance where customers are willing to pay for these improvements.

The application of incentive schemes in the form proposed by the AER are supported, including:

* Revenue at risk of ± 5%
* Performance targets based on the distributors’ average past performance over 5 years and
* Guaranteed service level (GSL) schemes not included provided they remain a part of the NSW jurisdictional scheme.

The focus areas of network performance and customer telephone answering remain important.

However, it must be noted that other areas of service delivery that are largely monopoly services by distributors remain somewhat outside the STPIS including:

1. *Non-contestable connection services*: where the network business provides technical standards, connection approval and the physical connection the parts of network and customers connections constructed by others. Despite the intent of rules such as Chapter 5A of the NER, the incentives for timely and customer-focussed connection services are not strong.
2. *Public Lighting*: where incentives for a strong customer and community service approach are lacking, as evidenced by emerging unrest from customers, councils and developers regarding the transparency of pricing, service response and performance outcomes provided by distributors.
3. *Response to complaints*:relating to the quality and timeliness of distributors’ responses to customer complaints and queries, where an increasing number are processes in written and electronic form, rather than contact by telephone.
4. *Planned Interruptions*:where network performance targets for planned interruptions are just as important as the response to unplanned and emergency work. Incentives to reduce or at least optimise the number, period and commercial impact of planned interruptions to customers would benefit from formal incentives to at least maintain current performance in a manner similar to unplanned interruptions.

The CCP would encourage the AER to consider the wider application of the definition of service targets and performance in upcoming determinations.

1. DMIS

The CCP recognises that the AER is currently developing its new scheme and allowance mechanism and in January 2017 published its DMIS/DMIA Consultation paper.

The CCP will continue to consult on demand management incentives, including with the NSW distributors, to ensure the impacts of this very important incentive are reasonably addressed with both the community and those businesses with emerging demand management aggregation capability.

In recognition that a large component of the success of a distributor’s demand management initiatives rely heavily on the technical and commercial relationship with customers, retailers and new industry entities such as demand aggregators, the development of the demand management capability in these sectors will be of interest to the CCP.

# Issue 4: Expenditure forecast assessment guideline

### AER’s preliminary position

The AER proposes to apply the Expenditure forecast assessment guideline (the EFA guideline)[[5]](#footnote-5) which was developed in consultation with stakeholders through the Better Regulation review in 2013. The EFA guideline provides for the AER to have regard to various sources of information and analytical tools in reaching its judgement on efficient costs. Importantly it imposes a requirement on the distributors for transparency in their forecasts of proposed costs.

The assessment/analytical tools and techniques specified in the EFA guideline include:

* models for assessing proposed replacement and augmentation capex
* benchmarking (including broad economic techniques and more specific analysis of expenditure categories)
* methodology, governance and policy reviews
* predictive modelling and trend analysis and
* cost benefit analysis and detailed project reviews.[[6]](#footnote-6)

The AER states that “*We* *exercise our judgement in determining the extent to which we use a particular technique in assessing a regulatory proposal*.” (p73 F&A).

### CPP view

The CCP endorses the use of the EFA guideline. The EFA guideline was developed in consultation with stakeholders and can provide a basis for the AER’s structured consideration of relevant information in coming to its view on the efficient costs for the supply of network services, consistent with the NEO and the requirements of the NER. Users strongly supported the EFA guideline but the key issue will be how the AER applies the guideline in light of the decision of the Australian Competition Tribunal (ACT) on the appeal by Networks NSW and ActewAGL, and the resolution of the subsequent appeal to that decision.

#### Users Support the EFA guideline

Users strongly supported the EFA guideline. In response to the draft EFA guideline UnitingCare Australia stated that ***“Uniting Care Australia is strongly supportive of the general approach that has been taken by the AER as described in the draft guideline.***  *We recognise the importance of each of the assessment techniques outlined in section 3.3 and supports the AER’s ability to utilise a range of assessment techniques*.”[[7]](#footnote-7)

However, users qualified their support for the EFA guideline with comments on the application of the guideline. For example, UnitingCare Australia expresses “***concerns about the interpretation of revealed cost as the process for determining base OPEX, specifically with regard to interpretations of efficiency of current expenditure.****”[[8]](#footnote-8)* PIAC emphasised the need for AER to “*use multiple sources of information, forecasting approaches and other methods*” and that some flexibility in the choice of assessment techniques, guided by the principles set out in the EFA guideline, would be required.[[9]](#footnote-9) Like other users, the MEU supported the increased use of cost models and efficiency models by the AER. However, the MEU also emphasised the importance of also using less complex tools, such as past trends in various cost benchmarks, to assess current efficiency and challenge cost projections.[[10]](#footnote-10)

#### The ACT decision

The issue of the AER’s use of economic benchmarking models to assess the efficient costs of the distribution networks was at the centre of the appeals to the AER’s 2014 decisions on the NSW and ACT networks. It is important to note that:

1. the ACT’s decision has been appealed to the Federal Court and
2. the ACT did not reject the use of the AER’s benchmark models but concluded that the AER had placed too much weight on these models at that point in time.

The ACT directed the AER to remake its decision on opex having regard to a broader set of information including “*using a broader range of modelling, and benchmarking against Australian businesses, and including a “bottom up” review of Ausgrid’s forecast operating expenditure*.”[[11]](#footnote-11) The ACT did not find error in the EFA guideline. Rather, the ACT found that the error arose because “*At a general level, … the AER placed too much weight on the outcome of the EI model. That, in the Tribunal’s view represents an exercise of the AER’s discretion about the use to which the EI model should have been put which was incorrect*.” However, as noted above, this decision has been appealed by the AER and judgement from the Federal Court has been reserved.

#### Application of the EFA guideline

The AER’s benchmarking model should continue to be an important part of its assessment of the efficiency of the projected costs. It is in the nature of benchmarking that the models are refined and improved over time and often the underlying databases become larger and more robust. Hence, it is expected that a number of the criticisms of the modelling undertaken for the previous tariff re-set will be at least partially addressed.

However, consistent with the users’ earlier comments on the draft EFA guideline, the CCP believes that AER should consider other relevant information in a transparent and structured manner. The AER should demonstrate that it explicitly considers the relative merits of the various pieces of information and how that information has been taken into account in, and impacted on, its decision. This would be consistent with good practice and reduce the risk of a successful appeal against the decision.

# Issue 5: Depreciation

**AER’s preliminary Position**

The AER proposes to use a forecast depreciation approach to establish the RAB at the end of the 2019 - 24 regulatory period.

**CCP view**

The CCP recognises that there is interplay between depreciation, inflation and the application of the CESS.

The overall objective is for customers to be paying no more than they need to, meaning that capex must be efficient; utilising the most cost-effective capex choices in response to any specific network capital repair or improvement. At the same time there also needs to be incentives for sufficient capex over time, meaning there should be no incentive to invest more heavily in equipment with a shorter life where a more efficient decision would be to invest in a longer life capital item. As discussed in Issue 3 Incentive schemes, consideration of the DMIS demand management / non-network approaches should always be weighed against a capex solution.

Inflation estimates also impact on depreciation rates because a higher rate of inflation, forecast or real, impacts on necessary rates of return on the capital use for investment and also impacts on the rate of depreciation, certainly in nominal terms, but often in real terms too.

The depreciation choices are to utilise forecast depreciation or actual depreciation to determine the value of the RAB at June 30, 2024 - the end of the regulatory period.

While intuition might suggest that actual depreciation would give a more effective value of depreciation, because it is based on what is known, the AER argues that when considering interplay between depreciation approaches and the CESS, there are strong incentives associated with utilising forecast depreciation. The AER stated: *“if there is a capex overspend, actual depreciation will be higher than forecast depreciation. This means that the RAB will increase by a lesser amount than if forecast depreciation was used. As a result, the distributor will earn less revenue into the future than if actual depreciation had been used to roll forward the RAB.”* (p75 F&A).

The CCP agrees that the incentives need to be on producing the lowest future RAB, in order to keep future network costs as low as necessary and to limit the risk of intergeneration inequity.

The same forecast approach to determining RAB at the commencement of the 2019 -24 regulatory period will be applied from the 2014-19 determination.

The CCP agrees with the AER that applying a forecast approach to depreciation is the best option since:

1. it is consistent with the previous determination,
2. provides incentive for a lower future RAB, and
3. works more effectively in tandem with application of the CESS.

**General comment on approaches to deprecation**

The CCP notes that the F&A does not specifically mention the method of depreciation to be applied by the NSW distribution businesses and we understand that this is perhaps more detail than is necessary in the F&A. However, the CCP notes that some network businesses have been seeking accelerated depreciation methodologies to be employed for future regulatory periods. We wish to flag our concern about any deviation from straight-line depreciation unless a clear benefit to consumers can be identified.

# Issue 6: Dual function assets

**AER’s preliminary Position**

The CCP notes that Ausgrid and Endeavour Energy operate dual function assets, whereas Essential Energy does not. The AER’s preliminary position is to:

1. apply transmission pricing rules to Ausgrid’s dual function assets ($2,020M, 14% of RAB) because doing otherwise would significantly impact Ausgrid's customers; and
2. apply distribution pricing rules to Endeavour Energy’s dual function assets ($227M, 5% of RAB) because, due to the nature of those assets, applying transmission pricing rules would not change their cost recovery—Endeavour Energy customers would still finance those assets.

The decision on the treatment of dual function assets is binding. The approach reflects a continuation of the previous regulatory approach and with current practice, and is supported by both Ausgrid and Endeavour Energy [[12]](#footnote-12).

**CCP view**

The CCP agrees with the AER in maintaining the current approach to the regulation of dual-function assets through:

1. a consistent application of the assessment in terms of materiality and function;
2. an awareness of the material cost impacts on customers and the distributors should the process change;
3. the demonstrated support of the distributors involved; and
4. the fact that the current position has been expressed publicly in the earlier determination and the opportunity for wider comment has existed previously.

# Consumer engagement

**CCP view**

Consumer engagement is not specifically mentioned in the F&A, yet it is a requirement of network businesses that they consult with consumer groups and stakeholders in developing regulatory proposals. The CCP has an explicit responsibility to provide advice to the AER about the effectiveness of the NSW distribution businesses’ consumer engagement.

The CCP suggests that it is time for the F&A to include reference to consumer engagement. As a starting point, we suggest that the F&A state an expectation that the 3 NSW distribution networks use ‘best endeavours’ to apply the Consumer Engagement Guideline (CEG) in developing their regulatory proposals. The CEG was developed in 2013 as part of the “Better Regulation” process and had extensive input from a wide range of stakeholders. It consequently provides a reasonable ‘minimum standard’ for consumer engagement in developing the 2019-24 regulatory proposals. Given that the CEG has been in place for about 4 years and so should be embedded in network approaches, we expect the NSW electricity distribution businesses to exceed the requirements of the Consumer Engagement Guideline.

1. http://www.energynetworks.com.au/electricity-network-transformation-roadmap [↑](#footnote-ref-1)
2. AER, Ring-fencing Guideline electricity distribution, November 2016; AER, Electricity distribution ring-fencing Guideline explanatory statement, November 2016 [↑](#footnote-ref-2)
3. AEMC, Competition in metering services information sheet, 26 November 2015 [↑](#footnote-ref-3)
4. Under the proposed revenue cap mechanism, if demand is lower than expected during a year, the lower revenues (and profits) in that year are offset by increased revenues (and profits) through higher prices in the next year, with a ‘wash-up’ correction after that [↑](#footnote-ref-4)
5. The AER was required to develop the EFA guideline under clauses 6.4.5 and 11.53.4 of the NER. The AER published the EFA guideline on 29 November 2013. It can be located at www.aer.gov.au/node/18864 [↑](#footnote-ref-5)
6. AER, Explanatory statement: Expenditure assessment guideline for electricity transmission and distribution, 29 November 2013 [↑](#footnote-ref-6)
7. UnitingCare Australia, *Submission on Draft EFA Guideline*, 2013, p3 [↑](#footnote-ref-7)
8. UnitingCare Australia, *Submission on Draft EFA Guideline*, 2013, p5 [↑](#footnote-ref-8)
9. PIAC, *Submission on Draft EFA Guideline*, 2013, p5 [↑](#footnote-ref-9)
10. MEU, *Submission on Draft EFA Guideline*, 2013, p12 [↑](#footnote-ref-10)
11. *Applications by Public Interest Advocacy Centre Ltd and Ausgrid*, [2016] ACompT 1 [↑](#footnote-ref-11)
12. Ausgrid’s letter regarding framework and approach paper and dual function assets for 2019-24 determination, 25 October 2016, p. 2; Endeavour Energy, Request to AER to update the framework and approach for the next regulatory control period, 25 October 2016, attachment A, pp. 1–2 [↑](#footnote-ref-12)